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TAGS: ECON EFIN PGOV EZ
SUBJECT: CZECH REPUBLIC: PUBLIC FINANCE REFORM BILL IS
FIRST TEST FOR NEW GOVERNMENT

REF: A. 06 PRAGUE 1239

¶B. 06 PRAGUE 1173
¶C. 06 PRAGUE 534

¶1. (U) SUMMARY AND COMMENT: The Topolanek cabinet on April 3 announced its long-anticipated economic and social reform package, and said it intends to link the bill to a vote of confidence in Parliament. The reform package falls short of simplifying the tax system but does undo many of the popular social spending bills passed in the run-up to the 2006 general elections that derailed the Czech Republic from its euro-adoption timeline. Preliminary reaction from economists has been relatively positive. A proposed cap on social security is a welcome development for U.S. businesses and Americans working in the Czech Republic.

¶2. (SBU) Politically, the proposed reforms are being criticized by the left for going too far and by some on the right for not going far enough. Not surprisingly, the opposition Social Democrats complain that many subsidies will be eliminated and pensioners, in particular, will face higher prices for necessities; they promise to oppose such "asocial reforms." More troubling, some within the ruling coalition have also announced they are not yet ready to support the package. With the parliament evenly split, and the coalition reliant on the votes of two opposition rebels for support, the fate of the package in parliament is not certain. If the government continues to insist that it will link the program to a confidence vote, it may need to consider restoring some of the more popular subsidies the bill intends to eliminate in order to ensure passage. END SUMMARY AND COMMENT

MACROECONOMIC CONTEXT

¶3. (U) The Czech economy has been growing at a record pace of over 6 percent for the last two years (fifth fastest in the EU behind Slovakia and the Baltic states). 2007 expected GDP growth is 5.8%. Exports (automobiles & machinery) and export-oriented foreign direct investments continue to drive this growth, although in the last two years, consumer spending has been increasingly contributing to GDP growth (over 5% in 2006). The increase in domestic consumption is attributed to income tax cuts, increased social transfers, a recent boom in consumer mortgage and other loans, as well as growth in housing construction and wages. Per capital GDP (ppp) reached 76% of the EU average in 2006, up from 73.7% in

2005 Newly-released Ministry of Finance statistics show foreign direct investment (FDI) inflows went from USD 11.7 in 2005 to USD 6 billion 2006; increased exports led to continued improvements in the trade balance from USD 1.6 billion to USD 1.97 billion. According to the IMF, inflation remains low and stable around 3% while core inflation is around 1%, reflecting strong central bank credibility.

IS THE ECONOMY HEADED FOR A DOWNTURN?

¶4. (U) While entrepreneurs are generally of the opinion that the Czech Republic has the potential to reach GDP growth levels beyond 6%, they see red tape, high taxes, high social and healthcare contributions, and over-regulation as key obstacles. Economists believe growth has already reached its peak and the first signs of a moderate slow-down are evident. They argue that the automotive industry has reached its maximum capacity and would not repeat the massive growth of the past two years until after 2009 when a new Hyundai plant becomes operational as the third major carmaker after Skoda Auto (owned by Volkswagen) and Toyota-Peugeot-Citroen Auto (TPCA).

¶5. (U) In this context, the traditionally business-friendly Civic Democrats (ODS) that now head the three-party coalition government with the Christian Democrats (KDU-CSL) and the Greens (SZ), have an opportunity to implement changes they talked about for eight years in opposition. ODS' focus is the "misused social state" based on the principal that it should be more advantageous to work than to be on social welfare. The current system, according to ODS, disincentivizes some income groups from seeking employment. The IMF has also concluded that a high tax wedge and generous entitlements discourage job search.

IT'S THE BUDGET, DUMMY

¶6. (U) In terms of the EU Maastricht Convergence Criteria, the Czech Republic's one glaring weakness is its lack of fiscal discipline. Despite the robust GDP growth, the general government budget deficit stood at 2% in 2005 but ballooned to 3.7% (estimated) in 2006. The 2007 budget deficit is estimated at 4.4% (CZK 122 million). The main culprits are the tax cuts and the significant increase in mandatory social spending in the run-up to the June 2006 general elections. The new public finance reform package seeks to reinstate fiscal discipline and push the deficit down to 2.6% by 2009, as reflected in the latest update to the Czech-EU convergence program completed in March.

REFORM PACKAGE DETAILS

¶7. (U) On April 3, the Czech government publicly released details of the long-anticipated economic reform package. Income tax rates would be cut to 15% for all income levels; the lower of the two VAT brackets (e.g. for food) would be increased from 5% to 9%; the standard VAT rate would remain 19%. In terms of social reforms:

EFFECTIVE 2008

-- a cap on social taxes will be put in place at a salary of CZK 80,000 (USD 4,000) per month, but deductions for mortgage interest, construction savings, and add-on pension insurance will decrease significantly for income groups that earn more than this figure.

-- retirement age will be raised to 65, and 35 years of service would be required to qualify for a state pension.

-- birth allowances will be reduced from CZK 17,760 to CZK 15,000 for the first child and CZK 13,000 for each additional child.

-- maternity allowances will decrease after two years (CZK

11,400 up to two years, CZK 7,600 up to 3 years, and CZK 3,800 up to four years) to motivate parents to return to work more quickly. Currently, the standard maternity leave is three years.
-- parental allowances will be limited only to those with household incomes up to 2.4 times the "living minimum" (less than CZK 22,560/month). This will reduce the percentage of families receiving child subsidies from 73% to 43%.
-- elimination of the one-time CZK 1,000 benefit introduced by the Social Democrats for familles with children entering first grade.

EFFECTIVE 2009
-- first three days of sick leave will not be paid at all, from day 4 - 30 benefits will be at 60% of wages, day 31 - 60 at 66% of wages, and 60 days at 72% of wages. The current rate is 25% of the wage for the first three days and 69% for any days beyond. The Czech Republic currently has one of the highest number of sick leave days taken among EU countries.

¶8. (SBU) Ministry of Finance Director of the EU and International Relations Department Eva Anderova told econoff April 2 that public finance reform should be discussed in Parliament this month, followed by separate tax reform package. She described the reforms as "not so revolutionary" that the opposition CSSD could not support it. In fact, she noted that much of the reforms were based on ideas CSSD put forth in its own reform agenda. Despite the political limbo in an evenly divided Parliament, Anderova believes the reform package will ultimately be supported by Parliament, if for no other reason than that the Czech Republic must adhere to EU convergence criteria.

EURO ADOPTION in 2012

¶9. (SBU) On March 13, the Czech government adopted an updated Czech EU convergence program aimed at adopting the euro in 2012, although it does not spell out the interim steps needed in public finance reform to reach that target date. The report is expected to be much criticized by the European Commission, but the government hopes that the EC will take the longer view on its ambitious reform targets. Anderova said it would be announced after the public finance reforms, and that Finance Minster Kalousek remains personally

committed to the 2012 goal. She admitted that the general public did not see euro adoption as either a goal or a motivator for economic reforms. She largely attributed that to the government not adequately explaining the benefits of euro adoption to the general public. The new Advisor to the Finance Minister Oldrich Dedek (former central bank vice-governor and now at the Charles University) is in charge of the government euro adoption strategy.
GRABER